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C O N F I D E N T I A L SECTION 01 OF 02 REYKJAVIK 000015

SIPDIS

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TAGS: [EFIN](#) [ECON](#) [PGOV](#) [IC](#)

SUBJECT: ICELAND ECONOMIC SITUATION EXPECTED TO DETERIORATE FURTHER  
BEFORE IMPROVING

Classified By: Amb. Carol van Voorst for reasons 1.4 (b) and (d).

REFS: A) Reykjavik 13 B) Evans - Reykjavik Morning Update emails  
1/23/09

1.(C) Summary: The Ministry of Finance's report on Iceland's economic health this week forecast a dismal eighteen months before recovery. This assessment was echoed by the new Chairman of the Government Coordinating Committee, Mats Josefsson, who is charged with creating a framework for restructuring the banking sector. Restructuring has been slow, but seems to be headed in the right direction, and Josefsson is confident that the IMF will be satisfied with their mid-February review. However, problems persist, such as the lack of an overall "Economic Czar" for Iceland to deal with other issues like the currency depreciation. Recent public unrest and uncertainty on the political scene are also complicating. Also unresolved are the issues with the old banks' creditors and the negotiations to settle the unsecured IceSave deposit accounts. Overall, the situation is tough and stressful and is testing the fortitude of the Icelandic people as well as their government. We expect that matters will deteriorate further before recovering. End Summary.

¶2. (U) "The Icelandic economy is heading for a deep recession in 2009 that is forecast to reach a trough in the first half of 2010," concludes the Ministry of Finance produced national economic forecast released this week. The summary goes on to say that Real GDP declined by a small margin in 2008, but is predicted to decline by 9.6 percent in 2009. Unemployment, previously at 1.7 percent in 2008, is predicted to average 7.8 percent in 2009 and 8.6 percent in ¶2010. Inflation, calculated at 12.4 percent in 2008, is expected to increase to 13.1 percent in 2009 and then decline to average 2.7 percent in 2010. The report recognizes that there "is considerably more uncertainty than before about most elements of the forecast" as the model relied on historically measured relationships, some of which have likely changed since the collapse of the banking system.

¶3. (C) Mats Josefsson, newly appointed Chairman of the Coordination Committee, and Gudmundur Arnason, newly assigned Director of Special Projects at the Prime Minister's Office, echoed these predictions to Econoff on January 23. Josefsson's mandate is to create a framework for restructuring the banking sector, and Arnason "makes sure the recommendations of the Committee are implemented by the ministers." Josefsson remarked that the government had let the banks handle everything over the last ten years and there was not the infrastructure in place to deal with the crisis. This led to inaction, and in hindsight, more could have been done more quickly in October. However, Josefsson said that the attitude is changing in the government and "there is a realization that things have to happen." He also said that he has advised the Icelanders that it is better to do things on their own before being told by the IMF to do things "the IMF way." Josefsson said that changes take time, but the direction is good and he was optimistic that the IMF will be satisfied with the first review.

¶4. (C) Regarding the banking sector, Josefsson said the new banks still need to be capitalized and must start lending, as a functioning banking system is necessary for the economy to recover. He said the business plans of the banks are OK, but the new banks need "to be cleaned up." He further clarified that since the creation of the new

banks, some of the healthy assets moved from the old banks to the new banks have deteriorated. Most of these are related to corporate loans and this debt needs to be restructured. (Note: Businesses are heavily in debt with foreign currency loans and with the krona's devaluation, and many are unable to service their debt. End Note.)

15. (C) Josefsson said that since the old banks are in moratorium (court administration), creditors must address issues with the Resolution Committees, and not lobby the Prime Minister's office. He said that the Resolution Committees need to be affirmed by the court to prevent committee members, or the Government who appointed them, from being sued. Financial advisors are in place at the banks, but the Government of Iceland, which is also a creditor, needs to have its own voice before these Committees. Once that official, whom Josefsson called a "spokesperson," is in place, then all the parties can get together to talk. Josefsson said there has been discussion about the bond or instrument that the new banks would provide as value for the assets removed from the old banks. He saw these bond negotiations taking two to three months, because some want to wait until the new banks start increasing in value to pass some of this value to the old banks, but the government did not want to pass back all of the value. He said the old banks' value still needs to be assessed and there has been some delay because it is very expensive to hire the necessary experts, who Josefsson felt were "taking advantage" of the situation for financial gain.

16. (C) When the U.S. Department of Treasury Deputy Assistant Secretary visited Reykjavik December 8 - 9, 2008, there was a visible lack of an "Economic Czar." It took two full days of meetings to obtain a coherent picture of the economic situation. In December, the Advisor at the Prime Minister's Office Bjorn Runar Gudmundsson, described his office as playing a coordinating role, but conceded

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there was a lot of misunderstanding and difficulty in getting "everyone to talk the same language." Gudmundsson had noted that the initial crisis was not managed well, coordination had been difficult, and that tensions in the political arena had been stirred up. Gudmundsson had mentioned three priorities - the currency, the fiscal policy, and the banks. Now in January 2009, it appears Josefsson has the banking sector reform laid out, but Josefsson was clear that his mandate does not extend to exchange rate issues. Also complicating matters is the current uptick in public unrest (Ref A) and the announcement the Prime Minister will retire from politics in March because he has cancer of the esophagus (Ref B). Josefsson said political stability is important as there has to be a government in place to implement these necessary changes.

17. (C) Further unresolved are the negotiations with the U.K., the Netherlands and Germany on the unsecured IceSave deposit accounts. At the Ministry for Foreign Affairs, Martin Eyjolfsson, the lead negotiator, said that the parties have agreement on the principle of paying the EU minimum deposit guarantee. However, to make the payments, Iceland will have to borrow from the other states in the short term, and disagreements persist on the interest rate, length of loan, grace period, and other terms. In mid-December, Eyjolfsson described the British and Dutch representatives as presenting a united front in the meetings, but having separate views on interest rates. The British wanted a 6.7 percent loan, which Eyjolfsson said could block Iceland from meeting the Maastricht requirements and bar Iceland from the Euro. Eyjolfsson said for every one percent in interest on the loan, there will need to be a corresponding 1.5 percent decrease in the state budget. Eyjolfsson told Econoff January 22 that negotiations were still ongoing and the next meeting with the British, Dutch and Germans together, was set for the first week of February.

18. (C) Comment: Overall, the aftermath of the October 2008 banking sector meltdown continues to test Icelandic fortitude, inside and outside government. All indications are that the economic situation will deteriorate further before recovering. Icelanders have a tradition of being flexible and hardworking. If they can adapt and endure the next six to 18 months, then they will have made it through the worst. However, the recent political turmoil and grave illnesses of the leaders of both Coalition parties only adds to the difficulties of recovery. End Comment.

VAN VOORST